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SUBJECT: BRAZILIAN MEDIUM-SIZE BANKS: KEY TO SMES

REF: A. Sao Paulo 0593; B. Sao Paulo 0548; C. Brasilia 1417

SENSITIVE BUT UNCLASSIFIED--PLEASE PROTECT ACCORDINGLY

¶1. (SBU) Summary: Representatives from five medium-size banks and the World Bank's International Finance Corporation met at Consulate General Sao Paulo on December 18 to discuss the operating environment for medium-size banks, major problems in the sector, and possible steps forward for 2009. They believe Brazil's banking sector is becoming more concentrated as a result of recent GOB measures; however, existing regulations and the prominent role of state-owned banks are factors that contributed to an already extremely concentrated banking system with the top 10 banks holding 80 percent of time deposits. Maturity mismatches between short-term deposits and longer-term loan portfolios have created some liquidity concerns, especially among mid-size banks. Medium-size banks play an important role in helping to diversify loan portfolios of small and medium enterprises (SMEs) in Brazil. Brazil does not have bank customers for mid-size banks to mirror the U.S. model of regional banking. According to the panel, the GOB needs to actively promote and create incentives for medium-size banks to survive over the long-term. SMEs play an important role in the Brazilian economy and massive failures of small and medium banks would impact the Brazilian economy. End Summary.

Representation

¶2. (SBU) Representatives from five medium-size banks and the World Bank's International Finance Corporation met at Consulate General Sao Paulo on December 18 to discuss the operating environment, major problems in the sector, and possible steps forward for 2009. The roundtable hosted by the US Treasury Financial Attache included Beny Parnes and Joao Carlos Pinho, Directors at Banco BBM; Andrew Gunther, Brazil Country Manager and Bruno da Cruz Carneiro from the International Finance Corporation; Cassio von Gal from Banco Fibra; Sergio Lulia Jacob from the Arab Banking Corporation (ABC) Brasil; and Andre Jafferian Neto from Sofisa.

Even More Concentrated

¶3. (SBU) Brazil's banking system is very highly concentrated. According to Fitch Ratings, at the end of June 2008, the 10 largest Brazilian banks by equity accounted for 78 percent of the banking

system's assets, 80 percent of deposits, and 69 percent of equity. Beny Parnes, Director at Banco BBM told Econoff that the concentration of the banking sector has significantly increased in recent years and that the credit crunch has increased market share for the six largest banks. (Comment: An example of this was the recent merger announcement of Unibanco and Itau to form the largest bank in Brazil. See Ref A for more info. End Comment.) Likewise, several panelists noted that the largest banks have benefited from the financial crisis as concerned customers moved their deposits to big banks (flight to quality), further concentrating capital in the hands of a small number of financial institutions. An example of this can be found in the relative amount of certificates of deposit (CDs) held by small and medium banks. From April to December 2008, CDs at small and medium banks went from 23 percent of total CDs to 11.5 percent.

¶4. (SBU) Parnes told Econoff that Brazil's regulatory framework does not stimulate more competition because it inherently favors larger banks. He cited as an example the recent Central Bank (BCB) and Brazilian Securities Exchange Commission (CVM) measures that encouraged large banks to purchase medium-size bank portfolios as further reducing market share for medium-size banks (Refs B and C). The panel discussed that Brazil's system of deposit guarantees also indirectly favors larger banks given their client base. The Credit Guarantee Fund (FGC) only guarantees deposits up to R$ 60,000 per person for banks that pay into the fund (administered by Febreban). As a result, the FGC primarily protects individual account holders, who are more likely to keep their deposits at the larger banks. Medium-size bank customers, mostly small and medium-size businesses (SMEs) with business accounts, have minimal protection under current regulations. Parnes underscored that Brazilian banks would find it

more difficult to attract deposits because of the lower deposit guarantees. Andre Jafferian Neto from Sofisa noted that Sofisa's branch in Miami was not facing flight to quality problems right now because of the U.S. federally insured deposits.

¶5. (SBU) Parnes further posited that the popularity of state banks, noting the perception that Brazilians feel more secure with state-owned banks, also undermined competition. Of the 10 largest banks, three federal banks, the National Development Bank (BNDES), Caixa Economica Federal, and Banco do Brasil account for 40 percent of assets, 45 percent of deposits, and 37 percent of equity.

Maturity Mismatches, Funding Concerns

¶6. (SBU) Parnes told Econoff that maturity mismatches are a huge problem in Brazil right now. Time deposits, the largest source of funding for Brazilian banks, are flexible and consumers can pull out money quickly, often resulting in maturities of one day or more. Parnes stated that 70 percent of time deposits held by large banks can be withdrawn before maturity. Bank loans, on the other hand, have a longer fixed term. He noted this problem was more severe in medium-size banks, but that large banks also had issues.

¶7. (SBU) The panel also highlighted that Brazilian banks have traditionally focused funding efforts on CDs and not on other instruments. According to Fitch, traditional deposits have provided about 50 percent of the Brazilian financial system's funding, and the remainder comes mainly from the domestic capital market. Even before September 2008, international markets provided less than 10 percent of funding, most of which primarily went to large corporations. In addition, the panel told Econoff that although Brazilian banks can issue bonds, Brazilian Treasuries crowd out private bank bonds.

¶8. (SBU) Low penetration rates for banking further limit funding opportunities for Brazilian banks. The BCB indicated that nearly 40 percent of Brazil's 5,500 municipalities do not have a retail bank or banking service window. Parnes noted that the majority of Brazilians do not have bank accounts because they are poor. Medium banks cannot compete with larger banks for the retail consumers and generally provide more commercial banking for SMEs, further limiting

their deposit base.

Medium-Size Banks and the SMEs

¶9. (SBU) The panel discussed SMEs performance amid the global credit crunch. Despite cutting down on new financing, the higher cost of capital on existing credit lines is choking otherwise good companies. They lamented that SMEs could not have expected to alter growth expectations from five percent down to 0 within two months time. Jafferian stated that the average interest rates on SME working capital loans were 17 percent per year in 2007, and had risen to about 23 percent by April 2008, and were 35 percent per year in December. He does not believe rates back down to 25 percent are possible in the near-term. They postured that the lack of new credit to roll over existing debt, higher borrowing costs, and lower revenues would mean higher defaults for SMEs in 2009. They all agreed that SMEs could start passing off any insolvency issues to the medium banks. Von Gal pointed out that no one wants a solvency crisis among the SMEs, especially the big banks.

Not Like U.S. Mid-Size Banks

¶10. (SBU) Jafferian noted that Brazil does not have the broker deposit system that exists in the U.S. Pinho agreed that U.S. regulations had artificially kept banks smaller and fostered the development of regional banks. Given the lack of penetration, Brazil cannot support regional banks. Unlike the specialization of services and sheer scale within the U.S. banking system, Jafferian stated that Itau and Bradesco hold a virtual monopoly on retail services because they had invested millions into software and other services. Smaller banks are unable to match these perks.

Where to Go from Here?

¶11. (SBU) The group spent considerable time discussing the future for medium-size banks. Von Gal questioned whether the GOB wanted to keep medium banks in the system and compared them to a Brazilian soldier going into battle in Iraq without adequate training. They agreed that the GOB needs to define a function for medium banks within the system and create the regulatory framework that supports it. Von Gal stated that medium banks for decades have suffered liquidity crises every four years, a pattern that does not allow for long-term planning. Jafferian stated that the BCB is well aware of the need for more banks and that medium banks keep total credit costs down and offer loans in which large banks have no interest. He also noted that medium banks also help diversify the risk across the system--a SME typically has financing from seven or eight banks. Jafferian, a representative of the Brazilian Mid-Size Bank Association (ABBC), said that ABBC was working closely with the BCB to find ways to help medium banks. As an example, Jafferian highlighted that the GOB had authorized BNDES loans for SMEs, in which BNDES would provide the funding, and medium banks would assume the risk.

¶12. (SBU) Attendees applauded the BCB's efforts to keep the financial system functioning and for its regulation of the banking system. Von Gal noted that the BCB would have to begin absorbing medium bank portfolios, which the group agreed would only happen after a series of other efforts failed. They all noted that GOB officials would likely fear personal liability repercussions under that scenario. Jacob pointed out that Brazilian banks cannot continue to operate based on the expectation for emergency measures. They all advocated diversification of funding and creation of new instruments as a positive way to preserve medium banks. They cited the Receivables-Backed Investment Fund (FIDC) as a new instrument that was created as a vehicle for small companies to get access to capital that could not go the IPO route. There are some 250 of these funds in Brazil that banks and asset managers contribute to, but are considered risky and have not yet started operating.

¶13. (SBU) Jafferian closed the discussion by stating that Brazil

has the most secure financial system in the world. Real estate loans are only three percent of total credit (and only two percent of GDP); auto loans, though problematic, have a liquid tangible value; Brazil's average default rate is three to six percent; the payroll-linked loans are solid because the public sector guarantee; many medium banks are well capitalized following IPOs last year; and BCB supervision is very good and requires all activities be recorded on the balance sheet.

Comment

¶14. (SBU) Due to the nature of the Brazilian banking sector, the near-term impact of the global slowdown on Brazilian SMEs is a concern despite the relatively limited use of international credit lines and the high capitalization ratios. While consolidation is a likely outcome under current conditions, even if the 10 largest medium-size banks merged, their combined efforts would not compare to any of the largest big banks in Brazil. Small and medium banks would need better market conditions and a higher degree of bank utilization among Brazilians to begin to gain ground in Brazil. Despite their limited size, however, SMEs are a very important piece of the Brazilian private sector that cannot afford to lose its primary fundingbase. End Comment.

¶15. (U) This cable was cleared by Embassy Brasilia and with the US Treasury Financial Attache in Sao Paulo.

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